MYTHS, MISCONCEPTIONS, BLIND SPOTS

Overcoming the Home Bias in Equity Investing

By Adam Hetts, CFA®
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The benefits of international investment include access across a broader market that may lead to long-term gains, enhanced income, and lower volatility. Yet considerable bias to U.S. investments persists in portfolios.

With improved valuation opportunities abroad and several key global elections behind us, many advisors are revisiting the mix of international exposure in their portfolios.

As a result, the industry has experienced substantial flows into international equities. Over the past three years flows into the Morningstar International Equity category have been more than triple the flows into the U.S. Equity category.

To examine home bias and other industry trends, we track average allocations across advisor models. Using a proprietary-model analysis database we’ve found that, even in the face of these large inflows, the average advisor’s global developed equity allocation consists of only 22 percent in international equity, even though the MSCI World Index consists of 40 percent (see figure 1).

It’s important to consider that no two countries have the same sector exposure footprint.

Given this persistent underweight to international equities in advisors’ portfolios, we think there is still plenty of potential for this trend of international fund flows to continue. We also believe that a number of myths, misconceptions, and blind spots influence investors’ thinking when it comes to international exposure. Here are the ways we see home bias skewing portfolios and our responses to the most common concerns we hear about investing abroad.

**MYTH: MULTINATIONALS MAKE A PORTFOLIO GLOBAL**

Myth: “Most large companies today are global, so it doesn’t matter whether I own a U.S.-based global company or an overseas-based global company.”

Because many of today’s larger companies have global sales and suppliers, some argue there is little benefit to diversifying stocks by geography. It is true that companies are more global than ever. For instance, 30 percent of the total revenue of companies in the S&P 500 comes from outside the United States.1

However, investing in multinationals through domestic markets doesn’t necessarily provide broad or balanced international exposure. It’s important to consider that no two countries have the same sector exposure footprint. The United States is skewed toward technology and healthcare sectors and the ex-U.S. portion of MSCI World has its highest concentration in financials and industrials. Therefore, an equity investor in solely U.S. equities may be subject to large biases to a short list of U.S. sectors (see figure 2).

Home bias is not solely a U.S.-centric challenge. U.K. investors face similar structural exposure issues. Their...
domestic market is dominated by financials and consumer staples. Similarly, asset allocators in Japan drift toward sectors such as industrials and consumer discretionary because these sectors drive the Japanese economy. Regardless of where investors are located, familiarity bias drives investment selection. Figure 3 shows these varying sectors for the three largest countries in the MSCI World Index.

These differences in sector exposures create structural challenges for U.S.-based investors as well as investors elsewhere, potentially leaving them vulnerable to being overweight or underweight to particular sectors and economies. True international investing may potentially alleviate these challenges because it allows access to different exposures.

**Misconception: All Global Managers Are Created (Globally) Equal**

**Misconception:** “I’ve allocated to global managers, so I have sufficient non-U.S. exposure.”

We often hear—and even more often see—the evidence—that financial advisors are going global by using global managers in portfolios. In fact, the Morningstar World Stock category is the second most-popular category in the Morningstar International Equity group for active managers and its constituent funds are held in 21 percent of our advisor portfolios.

Yet investors might not realize just how U.S.-centric many of these global strategies are. Figure 4 shows U.S. vs. non-U.S. exposure over time for each of the fastest-growing global equity mutual funds in the category, based on trailing three-year inflows.

Based on the factor breakdowns shown in figure 4, consider an advisor who moves 10 percent into one of these global managers. Given the U.S. exposure in these funds, only about 40 percent of that position on average—or 4 percent of the model—actually is being allocated to international equities. Global strategies can be compelling, but it is easy to overallocate to U.S. stocks with these strategies.

**Blind Spot: Income Portfolios**

**Blind spot:** “I’m an income investor and there’s no yield in equities.”

A third refrain we hear is that traditional equity portfolios do not offer enough yield to satisfy income needs. We believe
THINKING GLOBALLY, INVESTING LOCALLY
FIVE-YEAR ROLLING STYLE MAP OF EXPOSURES DRIVING RETURNS (JUNE 1, 2012–MAY 31, 2017)

Emerging Markets Equity  U.S. Sm Growth  U.S. Mid Growth  U.S. Top Growth  Cash
Foreign Equity  U.S. Sm Value  U.S. Mid Value  U.S. Top Value

35% Non-U.S. exposure

30% Non-U.S. exposure

55% Non-U.S. exposure

AVERAGE ADVISOR GLOBAL EQUITY ALLOCATION VS. MSCI WORLD STOCKS YIELDING 3 PERCENT AND ABOVE

Source: Janus Henderson

Top Five Sectors—Average Advisor Model

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Top Five Sectors—MSCI World Index: Stocks Yielding 3%+

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* Global Fund A has an inception date of March 2013.

Source: Returns-based factor analysis from Janus Henderson Portfolio Diagnostic Analysis. Produced with MPI Stylus Software.
this is a half-truth at best, because the yield on many portfolios is suppressed due to home bias and the resulting concentration in crowded, relatively low-yielding U.S. stocks.

For example, instead of comparing the average advisor global equity portfolio to the MSCI World Index we now compare it to stocks in the MSCI World Index yielding at least 3 percent and show the discrepancies among the top five sector allocations in each (figure 5).

The international high-income equity universe is arguably much larger than what most investors find in their more familiar U.S. hunting grounds. A properly diversified global equity portfolio should have the ability to provide meaningful income benefits on top of total returns and diversification, provided it suits investor needs.

**CONCLUSION: HOME BIAS PERSISTS, EVEN IN THE FACE OF GOOD INTENTIONS TO GO GLOBAL**

In our analysis of advisor portfolios, we see persistent home bias. When relying on U.S.-based multinationals and U.S.-skewed global managers for international exposure, it is important to be fully aware of potential shortfalls accompanying each approach. Otherwise, portfolios may be missing out on international equity income opportunities, not to mention the potential diversification of both growth and risks compared to U.S.-based holdings. Although international investments can present a unique set of risks that investors should consider carefully, adding foreign exposure can enhance portfolio diversification, potentially lowering risk over long-term horizons while allowing investors to take advantage of growth potential outside the United States. As such, we believe many advisors face a substantial opportunity to adjust portfolio allocations, now with a greater awareness of the role these mistaken beliefs may have in perpetuating home bias within equity allocations.

**ENDNOTE**


Past performance is no guarantee of future results. Investing involves market risk and it is possible to lose money by investing. Investment return and value will fluctuate in response to issuer, political, market, and economic developments, which can affect a single issuer, issuers within an industry, economic sector or geographic region, or the market as a whole. Diversification neither assures a profit nor eliminates the risk of experiencing investment losses. Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial, and information reporting standards, all of which are magnified in emerging markets. MSCI World IndexSM is an unmanaged, free float-adjusted market capitalization weighted index composed of stocks of companies located in countries throughout the world. It is designed to measure equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes.

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